

USAWC STRATEGY RESEARCH PROJECT

**THE NATIONAL SECURITY PERSONNEL SYSTEM: AN OPTIMIZATION
STRATEGY FOR IMPLEMENTING PAY-FOR-PERFORMANCE**

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ABSTRACT

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The National Security Personnel System, as published in the Federal Register, became effective November 28, 2005. One of goals of the NSPS is to provide a contemporary payroll system, more capable of fully rewarding Department of Defense employees. It will do this by linking pay to performance. However, while pay-for-performance seems to work well in demonstration projects, it has potential to precipitate unwanted attrition, create anxiety within the workforce, and erode employee trust. This paper begins by examining the goals of pay-for-performance and Government Accounting Office (GAO) reports on the results of recent pay-for-performance demonstration projects. It examines the tenets of organizations with successful pay-for-performance plans and provides evidence that pay-for-performance can achieve its desired results, even within a concept that, on the surface, seems to reward competition within groups. Ultimately, the paper provides key strategic concepts for managers to focus their efforts while implementing pay-for-performance—managing cultural change and maintaining effective communication and employee trust. While these concepts may not appear to be particularly groundbreaking, they have great potential to be underemphasized given managements' competing priorities.

THE NATIONAL SECURITY PERSONNEL SYSTEM: AN OPTIMIZATION STRATEGY FOR IMPLEMENTING PAY-FOR-PERFORMANCE

In an October 26, 2005 memorandum to Department of Defense (DoD) civilian employees, the acting Deputy Secretary of Defense, Gordon England, offered his congratulations to all who had worked so hard over the past two years to develop the new DoD civilian management system intended to replace the General Schedule (GS)—the National Security Personnel System (NSPS). In that memo, the acting Secretary referred to the NSPS as a “win-win-win” for all DoD employees, for the Department, and for the Nation. He also cited its primary objective, “to stimulate an environment where all employees can excel, can be challenged with meaningful work, and can be recognized for their contributions.” To achieve this objective, this move from the GS pay system to the NSPS involves one fundamental change to the way future DoD employees will be paid. NSPS rewards employees for their contributions to the workforce through a combination of market based pay and performance-based compensation (pay-for-performance) as opposed to the GS’s structured paygrade and longevity-based raises. The DoD is abandoning the GS system in favor of the NSPS’s pay-for-performance plan to shape a work environment that attracts, rewards, and retains the best talent for the Department of Defense.¹

Implementing a new pay system to develop such an environment is especially critical for DoD. The Department of Defense faces an aging workforce, stiff competition from the private sector for skilled employees, and mounting budgetary oversight from the congress. Additionally, the administration is placing increasing demands on employees to assume more risk and be more innovative, agile, and accountable than ever before. To adapt, the Department of Defense intends to transform the organizational culture of its human resources environment from an inflexible, one-size-fits-all system of defining work, hiring staff, managing, assessing, and rewarding performance, and advancing personnel, to one that is more agile, innovative, and accountable. To accommodate and facilitate this transformation, the Department of Defense plans to implement a more flexible and mission-driven system of human resource management—to replace the GS paradigm and shift to a new pay system strategy under NSPS.² While this may appear to be a radical undertaking for an organization as vast and diverse as the Department of Defense, it is not without precedent among very large corporations. Even corporate giants like IBM eventually had to replace their antiquated human resource practices to confront the realities of the present. Certainly, one could argue that DoD faces a problem similar to IBM’s and possibly, one that is more essential and complex.

However, while change may be called for, effecting changes that will result in re-shaping an organization's culture entails risk.³

This paper provides key strategic concerns for managers to consider during the transition to pay-for-performance. The goal of this paper is to minimize the risks associated with implementing pay-for-performance throughout DoD's civilian workforce. To meet this goal the paper will begin by examining the goals of pay-for-performance and Government Accounting Office (GAO) reports on the results of recent pay-for-performance demonstration projects. From there, it will provide evidence that pay-for-performance can achieve its desired results, and it will examine the tenets of organizations with successful pay-for-performance plans. Ultimately, the paper will provide key strategic concepts for managers to focus their efforts while implementing pay-for-performance—managing cultural change and maintaining effective communication and employee trust. These concepts may not appear to be particularly groundbreaking. One should take caution, however, not to assume they are inherent traits of competent management. Managing cultural change and maintaining effective communication and employee trust have great potential to be underemphasized given managements' competing priorities. As the research suggests, one must remain vigilant and engaged in regularly practicing these concepts if one is to gain the optimal benefits of a pay-for-performance system.

The Pay-for-Performance Concept

Under the current GS system, pay is tied to outdated, narrowly defined work definitions; and, exceptional employees are paid the same as those with marginal performance. As structured, the GS system assigns rote pay increases based primarily on time-in-grade—assuming the employee is performing at an acceptable level of competence. Over time, however, the requirement to achieve an “acceptable level of competence” has lost all relevance in the pay-increase decision process. For all practicality, pay raises are based solely on longevity. This claim is supported by the fact that roughly 99 percent of all GS employees are rated as having performed at an acceptable level of competence. As a result, at any given pay-grade level, GS employees expect and can count on, automatically receiving base pay increases—up to 30 percent over time. Eventually, even less productive employees progress to the upper pay bounds of their pay grade and end up being paid significantly more than higher-performing employees with less time in grade. While this creates an economic “comfort zone” for individual employees, it also creates a work environment with the potential to create animosity among employees. The goal of the NSPS is to transform the GS system's inherently weak and risky, one-size-fits-all system of defining work, hiring staff, managing people,

assessing and rewarding performance, and advancing personnel to one that can retain, develop, and recruit a workforce that can more capably meet the Department's 21st century needs.⁴

The NSPS pay-for-performance concept is designed to recognize and reward employees using pay as a motivator to shape the workforce to meet the Department of Defense human resource strategy. Unlike the GS longevity-based system of pay progression, under NSPS, employees will progress based on how they perform. NSPS will do this first, by establishing the guiding principle that no employee will receive a base pay or local market supplement increase if his or her performance does not meet or exceed expectations. Second, by providing individual base pay increases based on performance regardless of time in grade—whether by demonstrating requisite competencies at the entry/developmental level or by meeting or exceeding the performance standards at the full performance level.⁵

It is clear that implementation of these performance-based pay criteria will compel DoD employees to deal with a fundamental cultural shift to a more results oriented, customer, focused environment. One can expect this change will elicit a degree of skepticism among the DoD workforce. To support its ability to implement—and deflect criticism and scrutiny—statements in the *Federal Register* provide evidence that even within the Department, pay-for-performance is not a new concept. The Department contends that it has significant experience in administering pay-for-performance systems.⁶ From this one could infer that the Department of Defense is prepared and fully capable of effectively implementing pay-for-performance DoD-wide. In fact, Michael Dominguez, assistant secretary of the Air Force and head of the NSPS product team states that he, “has a lot of confidence that the Department can handle an effort that will transfer 650,000 civilian employees in 41 civilian personnel systems into a performance-based pay system.”⁷

One could reasonably infer from these statements that DoD has a proven capability to manage the cultural shift to performance-based pay, that it has the necessary experience to implement the most significant factor that determines whether organizations will successfully implement the transition to NSPS—cultural change. GAO analysis, however, suggests otherwise. According to GAO, DoD organizations would be wise to exercise particular caution not to take lightly, the resultant need to manage the cultural change resulting from implementing pay-for-performance. Their report on “Human Capital,”⁸ which included an examination of pay-for-performance demonstration projects, concluded that, “additional work is needed.” A summary of the report's concluding observations include:

- GAO supports expanding pay-for-performance within the federal government. However, GAO qualifies its support by stating that how pay-for-performance is done, when it is done, and the basis on which it is done can make all the difference in whether such efforts are successful.
- Organizations should make meaningful distinctions between top and poor performers with objective and fact-based information.
- High performing organizations continuously review and revise their performance management systems to achieve results, accelerate change, and facilitate two-way communication throughout the year so that discussions about individual and organizational performance are integrated and ongoing.
- Organizations should ensure that reasonable transparency and appropriate accountability mechanisms are in place to provide information to employees about the results of the performance appraisals and pay decisions.⁹

GAO's observations represent intertwined concepts. However, to distinguish the component characteristics of these observations and relate them to what studies or corporate experience consider as prescriptions for successful implementation of pay-for-performance, this paper addresses them individually as they relate to: corporate culture, communication, and trust.

Corporate Culture

In August 2004, 83 percent of companies considered their variable pay plans as only somewhat effective or not effective at accomplishing corporate goals. The main culprit...? According to 91 percent of the survey respondents who characterized their pay plans as "unsuccessful," the reason is a weak pay-for performance culture.¹⁰ What does this mean for the Department of Defense as it transitions from a "longevity and entitlement," to a performance-based, pay culture? The author suggests one could find answers by examining the experiences of corporations that were able to implement a successful shift to a pay-for-performance culture. For instance, Exelon (one of the nation's largest electric utilities),¹¹ considers creating a new corporate culture which includes a greater emphasis on pay-for-performance as one of its greatest leadership challenges. It cites the need for bold leaders who can be more nimble and more adaptive in an environment of unprecedented cultural change. Unfortunately, for Exelon, these were qualities not emphasized in the past. One could justify a claim that the Department of Defense has the potential to fail to place sufficient emphasis on these qualities, especially, since Exelon's needs mirror those employee responsibilities cited as necessary for the transformation of the DoD civilian workforce—from the GS longevity-based system to one that takes more risk, and is more innovative, agile, and accountable than ever before.¹²

Just as Exelon must realize that cultural transformation may prove to be the biggest hurdle it must overcome to successfully spiral-in performance pay, so must the Department of Defense. Based upon the experience of Exelon's chief human resources officer, one cannot simply implement a cultural transformation like pay-for-performance overnight. It also cannot be championed by one function (human resources) alone. Rather, it is a slow process that has to involve an organization-wide effort. At Exelon, management is careful not to underestimate the difficulties of leading cultural change. It considers cultural change to be an effort that is more like a continuous process rather than one with a tangible culmination point. Exelon has successfully managed the change in its organizational culture by placing increasing emphasis on pay-for-performance and by holding all employees progressively more accountable as it gains additional experience managing a performance-pay based workforce.¹³ The author contends that DoD is apt to encounter similar experiences and it should exercise equivalent caution and emphasis.

Employee Traits

Based on the size, increased scope, and diversity of its workforce, one could certainly expect that the Department of Defense presents an inherently complex pay-for-performance implementation environment. Because its implementation has the probability of precipitating an extremely arduous cultural change challenge, it is imperative that DoD supervisors and managers recognize key employee traits. How those traits impact employee responsiveness to performance-based pay may ultimately determine whether its expected benefits are achieved as envisioned by the Department of Defense as documented in the *Federal Register*.¹⁴

Risk Aversion

A March, 2004 study suggests that the use of pay-for-performance as a control mechanism to align employee and organizational interests, address employees' equity and justice concerns, and lower organizational fixed costs, should take employee risk preferences into account.¹⁵ The study's results provide issues for managers to consider during the spiraling-in of pay-for-performance. A summary of the results follows:

- The more risk averse the employee, the more likely pay-for-performance will increase their potential to seek other employment.
- Risk-averse employees may be willing to choose a lower pay-grade in favor of a less-risky pay package.

- It may be necessary to offer a significant premium in pay level to attract, retain, and motivate employees who are required to take on more risk than they prefer.
- The less risk averse the employee, the greater the positive effect of pay-for-performance on contingent pay satisfaction and organizational citizenship behavior (OCB).¹⁶

Overall, the results of this study indicate the need to carefully examine and consider the diversity of employees' aversion (or lack thereof) to risk. Employee risk aversion should be an important consideration in compensation research and design.¹⁷ The author suggests that these results are also particularly applicable to the Department of Defense. After 30-plus years of the GS pay system—with its relative job security and predictability as compared to private industry—one could easily presume that DoD employees are certainly risk adverse. These risk-averse behaviors could, if left unchecked, create impetus for DoD employees to seek other employment once faced with the change to a culture of performance-based pay. On the other hand, if DoD managers wish to retain risk adverse employees they may have to offer higher than anticipated pay incentives. For DoD new-hires, one could reasonably expect that they will exhibit less risk adverse characteristics and, therefore, more potential to respond positively to pay-for-performance.

Organizational Commitment

A precursor to the March 2004 study (circa 1992), also highlights the importance of recognizing employees' traits—attitudes in this case—when changing to a performance-based pay culture. The particular attitude studied, examined employees relative to their propensity to exhibit commitment to their organization. The study refers to this trait as organizational citizenship behavior (OCB).¹⁸ For employees who are less inclined to exhibit a commitment to the organization, pay-for-performance acts as a disincentive. The stronger such employees perceive the linkage of pay to performance to be, the less likely they are to engage in OCB. In contrast, pay-for-performance plans do not discourage OCB for value-committed employees.¹⁹

One should expect this to be especially important for the Department of Defense as it embarks on the cultural changes associated with pay-for-performance. Surely, DoD managers will encounter some of the same reactions to pay-for-performance demonstrated in this study. Specifically, for some employees, pay-for-performance may have negative consequences for the organization unless management recognizes individual employee levels of OCB and intervenes. Some employees will choose to opt out and seek other employment or retire. Those who feel threatened that remain may exhibit gradually declining performance levels. Clearly,

DoD employees—especially, those who feel threatened by performance pay and who tend to display little OCB—may require extra attention to ensure they understand the reasons and benefits of pay-for-performance. A management team that is aware of employees' relative commitment to their organization will be more able to recognize and effectively react to employees' reactions to pay-for-performance implementation. Managers who understand their employees' OCB levels and resultant reactions to pay-for-performance will be better prepared to retain and optimize their workforce.

Utility Analysis²⁰

Given the aging DoD workforce, and increasing competition from the private sector, how will the Department of Defense be able to achieve a competitive advantage in its quest to maintain a quality workforce? Certainly, the implementation of pay-for-performance will attract new pools of potential employees, however, it will also precipitate employee turnover. The Department of Defense must consider the potential of an employee turnover dilemma.

One can characterize this turnover within DoD organizations as either functional (active or passive attrition of poor employees) or dysfunctional (failure to retain the best performing employees) (Boudreau, 1991; Boudreau & Berger, 1985; Hollenbeck & Williams, 1986; Trevor, 2001). Research, over the past two decades, has shown that both undesirable and highly desirable employees are generally more likely to leave an organization than average performing employees (Jackofsky, 1984; Trevor, Gerhart, & Boudreau, 1997; Williams & Livingstone, 1994).²¹ The key for the Department of Defense will be to minimize the loss of star employees and bring out the best in average performing employees.

Research reviews reveal ample evidence that pay-for-performance and higher performance at the individual level enjoy a positive correlation. This is good news. The Department of Defense should be able to tailor its pay-for-performance compensation system to enhance organizational value by targeting retention-based pay-for-performance efforts at the individual level. However, as mentioned earlier there are attrition and monetary costs associated with implementing pay-for-performance. Given, DoD will always be faced with balancing the need to optimally reward its best employees while being subject to stewardship, scrutiny, and resultant congressional limitations, will the benefits of pay-for-performance initiatives outweigh their costs? Utility analysis studies help to provide some answers.

Since most would agree that any cultural change requires top-down support, an essential task for the successful implementation of any pay-for-performance system would be to gain the trust of management in the plan's ability to improve the organization at reasonable cost. Trevor,

et al. (1997) provides a potential balance by allocating pay increases across employees at different performance levels. Their research revealed that pay policies that provided greater pay growth for high performers (and less for poor performers) substantially increased retention among high performers, encouraged separation among low performers, and thus, increased the value of the workforce.²²

This analysis, however, does not account for potential costs attributed to the movement of workers into and out of the workforce and costs required to retain and support the workforce.²³ One can assume that management would want to be assured that the pay-for-performance benefits of a workforce that provides greater value to the organization would not be offset or overcome by its costs (employee turnover, retraining, and recruiting). Managers might question whether they will have to manage more employee turnover, face an increasingly disgruntled and suspicious workforce, and be forced to jockey for a fair share of pay-for-performance funds. Again, the research reveals good news. By quantifying the potential retention benefits of performance-based-pay in dollar terms and comparing those benefits to the costs of performance-based pay, it becomes clear that investments in performance-based-pay may hold the potential for significant organizational improvement. However, this does not become apparent until one takes into consideration the potential benefits of performance-based pay on worker retention—increased retention among high performers and increased separation among low performers.²⁴

In fact, research using utility analysis shows that implementing pay-for-performance over a 4-year period could result in an increase in investment value of nearly 16% over a pay strategy that gives employees the same average pay increase, regardless of performance level (i.e., a strategy similar to DoD's current General Schedule system). Utility analysis revealed that the calculated highest payoff for pay-for-performance was achieved with an aggressive pay strategy.²⁵ This strategy provided no pay increase for the poorest performing employees and from there, linear increases in pay to the top performing employees. This more aggressive performance-pay strategy also included the assumption that higher performing employees were valued and retained much more than average employees and low performers were valued and retained much less than average employees.²⁶ Further examination of utility analysis research revealed that this more aggressive pay strategy produced greater benefits than one that employees perceived as rewarding some and appeasing most (a pay strategy not unlike many current DoD organizations). Additionally, the pay strategy that employees perceived as providing high pay increases to high performers and average increases for all other employees also proved less successful.²⁷

Applicability to the Department of Defense

This should be especially refreshing for DoD managers who may have doubts about the zeal with which to implement and support pay-for-performance. Will they lose employees? Yes. Will they encounter dissent? Yes. Will they have to develop new employees? Yes. However, according to the research cited above, all of that is to be expected and it is, “o.k.” Utility analysis provides evidence that managers can rest assured—things will work out in the long-run. They will be able to maintain their core support of more fulfilled key top performers and they will lose their sub-standard and “difficult” employees. Attritted employees, however, will be replaced by employees who, with negligible exception, will be at least average—and potentially high performers—because they will have been attracted to the position based on both the job’s description and performance-based pay.

Again, this is all good news that lends additional support to the notion that, pay can serve as a motivator. Successful management of performance-based pay can produce beneficial outcomes for both the organization and its employees. For the employer, it encourages behavior (OCB-like, especially in those that are less risk averse) that enables employers to optimize the performance of their staffs. For the employee, it has merit for its exchange function (ability to be exchanged for most goods and services), and as an indicator of relative success in life.

This does not discount the likelihood that cynics might persist in trivializing the effectiveness of pay-for-performance. Especially, those who have had experiences where pay-for-performance failed to provide the desired employee behavioral changes and organizational benefits. Such claims have some basis in fact. Many performance pay success stories are based solely on anecdotal testimonials and one-time company cases rather than on technical studies verified by experience or observation.²⁸

To counter the cynics’ argument, one must first examine or participate in organizations that have correctly implemented and achieved the desired results with pay-for-performance. Put simply, although pay-for-performance is meant to improve behavior, it is often aimed at the wrong behavior. To avoid this pitfall, managers could optimize the effects of pay-for-performance by ensuring that employees have a clear understanding of exactly what critical requirements relate to their performance and how management will objectively measure employees’ attainment of those requirements. Once that is established, further optimization could be achieved if managers are able to determine what stimulates the occurrence of the critical performance-related behavior (training) and what may be impeding it (inadequate or outdated technology). Finally, the manager (ideally) should dole out performance-based

rewards so they are contingent on the employee doing the prescribed and measured critical performance-related behaviors and then continually evaluate those behaviors. These steps help to ensure that performance-based-pay continues to encourage optimal performance improvement.²⁹

However, no matter what steps the manager takes, his employees remain his ultimate determinate of success. Macheiavelli observed that the proponents of change have many enemies. Those who have done well under the old system (the GS for DoD employees) may resist change because it reduces their acquired level of comfort. Even those who will eventually do well in the post-change environment will only be lukewarm defenders of the change. Their natural reaction will begin with recognition of the risk involved in change. Risk recognition will be followed by a period of hesitation. At this point, employees will wait to see how things evolve before they convince themselves that it is in their best interest and it is practicable to commit to the change. One can expect the transition to pay-for-performance will involve similar periods of transition. The Department of Defense will have to transition from a culture steeped in the history of the General Schedule. For this reason (in spite of the evidence of resultant pay-for-performance benefits cited in management theory and research since 1978), one can expect the transition to pay-for-performance will require a larger share of leadership's focused attention. Employees at all performance levels will surely feel that an additional level of risk has been thrust upon them. Therefore, to effect a successful cultural change, DoD leaders will have to communicate a compelling reason for implementing performance-based pay and they will have to ensure employees become active participants in the process of adopting the change to overcome the additional level of risk perceived by their employees.³⁰

Communication.

Perhaps, the most important thing leaders can do is to articulate clear, compelling reasons for shifting from the GS system to pay-for-performance.³¹ In its January 2004, review of Human Capital, GAO established communication as a key factor in ensuring successful implementation of performance-based pay systems. To that end, continuous, effective communication during the spiral transformation from the GS pay system to pay-for-performance offers another key element to ensure the success of pay-for-performance.³² DoD certainly recognizes the importance of, and need to, implement an alternative pay strategy to the GS system. In the section of the Federal Register devoted to the NSPS and Pay-for-Performance, DoD presents its "Case for Action." This section begins immediately following the introduction, an indicator of

its relative importance. DoDs case for implementing performance-based pay begins with a discussion of the detrimental attributes of the current GS system:

- It is incapable of adequately addressing the 21st century national security environment.
- Its inherent weaknesses make support of DoD's mission costly, complex, and ultimately risky.
- It encourages a dispute-oriented adversarial relationship between management and labor.
- Its systematic inefficiencies degrade the potential effectiveness of the Total Force.

It is followed by the intrinsic benefits associated with the NSPS and Pay-for-Performance:

- Enhanced opportunities for individual career growth and mobility within the Department.
- Promotes a performance culture in which the performance and contributions of the civilian workforce are more effectively recognized and rewarded.
- Generates more opportunities by easing the administrative burden routinely required under the GS system.
- Provides an incentive for managers to turn to DoD civilians first when certain vital tasks need doing rather than turning to contractors or military personnel.
- Continues employees' and labor organizations' rights to challenge or seek review of key decisions.
- Includes rules to guard against arbitrary actions.
- Incorporates fairness as an intrinsic quality of its design—one to be accounted for during reviews and evaluations of NSPS operations and decisions.³³

In addition to the Federal Register, the Department has established a NSPS website.

This website includes a comprehensive list of training materials, fact sheets, and answers to frequently asked questions along with implementation news and updates. This evidence clearly establishes that DoD recognizes the need to articulate compelling reasons to its employees to adopt pay-for-performance.

For employees, however, DoD's efforts to communicate the need to shift to pay-for-performance could have potential to regress into an "information-pull" rather than an "information-push" effort. While data detailing DoD's NSPS and pay-for-performance is available in various media forms (online, pamphlets, etc.), employees must seek it and sort

through it on their own time to establish and evaluate their perceived motivating or dissuading attributes of pay-for-performance. To avoid this pitfall and keep the GAO tenet of “effectively communicating pay-for-performance,” DoD leadership should be persistently engaged, actively “pushing” the benefits of, and need to shift to, pay-for-performance down to its employees. Based on the research and analysis of those who have successfully implemented pay-for-performance plans, doing so will help to avoid the biggest downfall firms encounter: lack of clear communication of employee and employer goals and requirements related to the performance plan. Corporate experience reveals that communicating “the need” (to shift to performance pay) gets tougher as your firm gets bigger.³⁴ One could assume that this corporate experience also provides a critical consideration for the Department of Defense. Especially, given the logical presumption that DoD with its numerous and diverse organizational elements possesses the characteristics of an extremely large firm. It follows that the Department must maintain its commitment to engage in active communication with its workforce during pay-for-performance implementation.

In some cases, this extends beyond what one might assume to be effective communication. In fact, organizations with successful pay-for-performance plans cite the need to *over-communicate* to achieve the best results. Their observations and experiences show that a well-communicated reward strategy can branch out to create a level of employee engagement that results in tangible benefits to the organization. Such strategies require continual, consistent managerial involvement because often times employees perception of effective communication of organizational programs differs widely from that of their employers. As evidence, 70% of employers say they do at least a fair job of communicating business strategies to employees, while only 38% of employees say that information needed to accomplish their work is widely shared.³⁵ These results should provide an incentive for DoD to err on the side of conservatism when it self-evaluates its efforts to get the word out on NSPS and pay-for-performance by remembering to “over-communicate.”

While the Department of Defense certainly has large amounts of information on NSPS and pay-for-performance available for employees from various forms of media, it may be irrelevant if not successfully communicated. The experience of other companies indicates that their efforts to implement new organizational programs lose impact if they utilize the wrong type of communication. A case study of a Chemical company that outranked three other manufacturing businesses in nine different effectiveness categories traced the company’s success directly to the amount and kind of communication about its reward plan. They achieved the best results when communication was done face-to-face, and it addressed roles,

accountabilities, and results, at the individual level.³⁶ The same tack can be applied to DoD's implementation of performance pay.

For DoD, the point of communicating the compelling reasons to shift from the GS schedule to pay-for-performance is to persuade employees as well as to inform them. The intent is to develop cooperative intra- and inter-organizational relationships and to continually reinforce and strengthen those relationships to ensure successful assimilation of performance-based pay into the culture of the DoD workforce. A "to-do" list to encourage free-flow communications and develop such relationships appeared in a Michael Hayes, June 2002 Journal of Accountancy article on pay-for-performance. In it, Hayes lists communication related tasks that accounting firm partners should engage in to promote performance pay. For the purpose of comparison, one could equate accounting firm partners to DoD division or directorate chiefs as the tasks and responsibilities regarding implementation of new organizational programs are comparable. Paraphrased to apply to DoD organizations these tasks include:

- Taking advantage of opportunities to engage in spontaneous face-to-face chat or lunch at least once a week.
- Telling other division chiefs and directorates what's going in your organization that may have implications for them.
- Ensuring it is clear to your employees what you expect from them and what they should expect from you.
- Holding monthly division and directorate meetings to communicate major issues and solicit feedback.
- Using meetings to tackle major issues before addressing the little ones.
- Treating conflict as an opportunity to resolve problems.
- Hold annual offsites--with enough lead time to solicit input and develop an effective agenda for them.
- Providing a strong motivator to encourage optimal performance by utilizing a program of written goals and evaluations that links pay to accountability.
- Providing a more even-handed and growth-focused process by placing employee performance criteria in writing.³⁷

These tasks (as they were originally worded) were presented to provide a comprehensive communications strategy for the accounting firm. They were presented as a template, intended to foster a free flow of information in order to capitalize on the synergistic benefits of teamwork,

cross-functional communication, and mutual support. One could also attribute these tasks to the implementation of pay-for-performance in DoD. It is suggested that, if practiced with consistent regularity, they would enable DoD managers to develop a workplace environment where pay-for-performance implementation had its best chance for success.

To ensure pay-for-performance achieves DoD's goals, its leaders must be the primary communicators and implementers of the plan. Leaders must champion the transition by example, know the strategic goals associated with pay-for-performance, identify with the DoD human resource community's rewards philosophy, and understand the responsibilities of the pay-for-performance program and the program's details. It is of paramount importance that DoD managers do all this while communicating truthfully and candidly, while being willingly held accountable if they are to optimize their potential to successfully implement pay-for-performance. In this regard, the scope of the requirements on DoD leadership cannot be underestimated. Clearly, the success of pay-for-performance will be a direct function of the amount and quality of training provided to managers. Managers must have a clear understanding of what pay-for-performance means for them, their employees, and their organization if one expects them to successfully communicate the need for the shift and effect the cultural changes that accompany its implementation.³⁸

As stated earlier, there is a financial motivator aspect that can be exploited to assist with the transition to pay-for-performance. However, while performance-based pay may be enough of a motivator to nurture initial employee support for the change, eventually the tangible reward becomes less important. The financial incentive of performance pay alone will not be enough of a motivator to ensure it continues to produce benefits to the organization over the long term. This is why the manager's role in communication, throughout the cultural shift to pay-for-performance, is critical to its eventual success. While the prospects of pay incentives will gain the initial support of employees, for it to be a continued source of benefit to the organization, employees will still have to progress through a cultural shift. This transition involves successful incorporation of pay-for-performance into their normal work routine to precipitate the desired behavior sought by implementing performance pay. Only then, will employees begin to see the intrinsic benefits of performance-based-pay. At this point, the tangible benefits of monetary reward become less important. Employees understand the dynamics of what they do and appreciate how all of their efforts tie together to benefit both themselves and the organization. The ultimate goal of effective managerial communication is to reach this point. Once attained, the behavioral changes sought by shifting to performance-based pay become inherent in employees' job performance.³⁹

Trust

As noted, research reveals that pay-for-performance plans—especially aggressive ones that identify and make clear reward and disincentive distinctions between their lowest and highest performing employees—result in net tangible benefits to organizations. However, implementation of performance based pay is not without some negative consequences.⁴⁰ These negative consequences and the ability to maximize the benefits of performance-based pay are best managed by effective communication and training plans that enable employees to understand the dynamics of how their efforts tie to meet organizational goals. Once again, effective communication plays a key mitigating role, this time, as a precipitant to management's ability to gain employee trust.⁴¹ Perhaps the synergistic “glue” that ties these elements together resides in the level of trust that management and employees are able to cultivate in each other regarding the benefits to both as a result of performance-based pay.

Given the anxiety related to the cultural shift to a pay-for-performance system and the inherent competition it injects across the workforce, how will such a large, complex, and diverse organization like the Department of Defense be able to gain and maintain the trust of its employees in this new performance-based pay environment? How does one cultivate an environment of trust? First, on the list of tasks, might be to address the issue of fairness. Employees or employers, who view pay-for-performance as unfair, will most likely not assimilate it into their inherent job performance. However, a structurally fair program is not in itself enough to convince employees to adopt pay-for-performance. Structural fairness is not synonymous with consistency. Both combine to form two distinct but essential elements necessary to nurture trust. Management must make this distinction clear to its employees.⁴² This is especially important for the Department of Defense. The General Schedule pay system's rigid structure developed a culture where considerable time, money, and energy was devoted to applying personnel programs consistently across organizations (though it could be argued that this resulted in treating unequally-performing employees equally).

Prior to NSPS, a comfort zone of trust among DoD employees relied largely upon the consistency of the GS pay system. The performance pay culture, however, requires a different managerial tact. To gain trust, DoD managers must establish a culture in which defines fairness through its inconsistency. Depending on their capabilities and job requirements, not all employees will be rated under the same guidelines or expectations. This will require DoD managers to adopt practices that promote the concept that it is not fair to treat everyone as equals. The diverse make-up of the DoD employee pool virtually guarantees that those employees will have different motivational “trigger points,” skills, and abilities, and they will make

different contributions to their organizations. Such diversity indicates a call for active managerial involvement both to help establish employee requirements and then hold them responsible for meeting those requirements.⁴³

One way to start movement in this direction is to establish an environment of universal accountability. This may sound counterintuitive, as it invokes perceptions of micro-management and coercive oversight. However, while they should consistently act to avoid the possibility of such perceptions, it is imperative that managers at all levels collect and use negative data. If managers are negligent in recognizing failure, neither they, nor their employees will be equipped to fix failure. DoD managers must have the courage and willpower to hold employees accountable for the achievement of their mutually agreed upon performance related goals. To maximize effectiveness and foster a universal opinion of fairness, this must apply equally at all levels of pay to include top management.⁴⁴

An organization's efforts to hold all levels of its workforce accountable—to include top management—also helps gain employee trust. Management's ability to develop a feeling of trust throughout the organization will have a positive correlation with its ability to minimize the potential for employees to view it as an initiative steeped in cronyism. This is important because one of the most common fears about pay-for-performance, under NSPS, is that managers will slant annual performance evaluations to reward their favored workers rather than their best performing workers. To counter this and gain employee trust, managers must be held accountable for being good managers. According to Clay Johnson III, deputy director, Office of Management and Budget:

This means they must sit down individually with each of their employees and clearly identify what meets expectations and what exceeds expectations. They must provide actionable comment—oral and written—about how each of their employees performed relative to these mutually agreed upon expectations. Finally, if the employee is not satisfied with the evaluation, is it made clear to him or her that all the regular appeals rights still exist? The key is to have numerous checks and balances to ensure an environment of fairness.⁴⁵

An additional necessity to foster an environment of trust involves ensuring employees believe that pay-for-performance will recognize them for their contributions and fairly compensate them for having met the goals associated with those contributions. The system will have effectively placed your job destiny in your own hands and will have eliminated any concern over the question, "If I do a good job, will anyone know?"⁴⁶ Experts in the field seem to believe the ultimate determinate of trust—as it relates to receiving just compensation to match contributions—rests in the level of transparency of the details of executing pay-for-performance. According to David M. Walker, head of the Government Accountability Office:

Recognizing that no performance system is perfect and all will contain some level of subjectivity, you have to make sure you've got a system in place that maximizes the chance of consistency, and minimizes the chance of inequity. Any plan should clearly delineate what you as an employee are required to do, what 'meets expectations,' what an 'outstanding' or 'role model' or 'exceeds' or what 'below expected' is.⁴⁷

Clearly, the head of GAO places transparency of pay-for-performance at the top of his list of necessary requirements to counter any predisposition to render accusations of cronyism. John Gage, president of the American Federation of Government Employees, also cites the importance of transparency. His comments indicate concern that a great potential for continued absence of transparency. They reveal an opinion that there must not be any instance where measurement criteria items related to the evaluation of employee performance are available to employers to see but not employees. Otherwise, as Clay Johnson, III states, employees will not be able to maximize their contributions because they will not know what is most—or least—valued. The remarks of these experts lead to the conclusion that management cannot possibly expect optimal employee contribution to the “team” if they do not know the rules of the “game.” Certainly, the level of transparency of pay-for-performance related goals, requirements, and evaluations is imperative. It must be preserved, beginning before actual implementation and it must continue throughout the cultural shift process associated with performance-based pay if one expects to earn and maintain employee trust. DoD leadership should champion, and all levels of DoD management should ensure, the transparency of all aspects related to the execution of NSPS's pay-for-performance element. Without transparency and the ensuing levels of employee trust it generates, the full benefits of performance-based pay will remain unattainable.

Conclusion

Although downsized to approximately 11,000 employees, Spiral 1.1 of NSPS (including its pay-for-performance aspects) begins April 30, 2006. The rating cycle will extend through October 2006 and the NSPS payout (the execution of NSPS's pay-for-performance piece) will occur in January 2007.⁴⁸ This paper examined the intent and managerial concerns relating to pay-for-performance and addresses two of the three major personnel issues the Department of Defense faces relating to performance pay implementation. These issues are: Using compensation to compete more effectively in the broader labor market, which as the research suggests, will also facilitate staffing the enterprise to support 21st Century.⁴⁹

While there are other key considerations facing DoD managers as they begin to execute NSPS and its performance pay component, this paper focused on those grounded in peer-

reviewed research. It is hoped that by focusing on the key considerations related to cultural change, that this paper might serve as a resource that enables DoD managers to be more capably armed to optimize their implementation efforts and the resultant composition, potential, and performance of their staffs. Cultural change will be hard to achieve. However, employees will perform if held accountable. If implemented correctly, any “pain” experienced during the change to performance-based pay will work out for the betterment of the organization.

Effective communication and building trust are also key elements of a successful performance pay implementation. The practices related to the notion that managers should “over-communicate” is especially important because it will help employees internalize the pay-for-performance culture. It will also assist with management’s efforts to maintain the concept of transparency, help employees understand that fairness does not mean treating all as equals, and assist managements efforts to develop an environment of trust. When integrated, the practices related to these concepts—cultural change, communication, and trust provide a sound optimization strategy to for the implementation of NSPS’s performance-based-pay plan.

Endnotes

¹ Acting U.S. Secretary of Defense Gordon England, “National Security Personnel System,” memorandum for Department of Defense Civilian Employees, Washington, D.C., 26 October 2005.

² Rules and Regulations, “Part IV, Department of Defense, Office of Personnel Management 5CFR Chapter XCIX and Part 9901 Department of Defense Human Resources Management and Labor Relations Systems; Final Rule,” *Federal Register* 70, no.210, (1 November 2005), 66117-66118.

³ Michelle Conlin with Robert Berner, “A Little Less in the Envelope this Week,” *Business Week* “ (18February 2002): [database on-line], available from Lexis-Nexis; accessed 9 November 2005. “A decade ago, the deal didn’t get any better than at IBM...salaries rose dependably each year.” However, faced with increasing competition and a realization that its one-size-fits-all compensation strategy was not appealing competitive, IBM changed its entitlement culture by instituting pay-for-performance. A primary motivation was to be competitive in the ‘90s “war for talent.” One could accurately presume that this is equivalent to what DoD faces today.

⁴ *Federal Register*, 66124.

⁵ Ibid. To summarize the NSPS pay-for-performance concept...The higher the performance the higher the pay. Pay-for-performance does not assume individuals are motivated by pay. The intent is to establish an environment where the DoD has an obligation as an employer to reward the highest performers with additional pay—however they may be motivated to achieve excellence. It is believed such a system will inspire employees to perform at their best.

⁶ Ibid., p. 66139. Pay for performance systems similar to the NSPS concept are not new. Pay banding has been part of the DoD compensation plan since 1980. The Department has significant experience in implementing and evaluating pay-for-performance based pay systems (e.g., demonstration projects). At present, approximately 44,000 of the Department's employees are covered by performance-based pay systems.

⁷ Jim Garamone, "Officials Express Confidence in New Civilian Personnel System," *American Forces Information Service News Articles*, 1 November 2005, [news article online]; available from http://www.defenselink.mil/news/Nov2005/20051101_3211.html; available from Lexis-Nexis; accessed 9 November 2005. This statement loses some of its impact later in the article when Dominguez goes on to state that, "we have very, very high confidence that we have *got this nearly right*..." He is counting on high quality leaders and employees to fill in the gaps and make pay-for-performance work.

⁸ U.S. General Accounting Office, *Human Capital: Implementing Pay for Performance at Selected Personnel Demonstration Projects*, (Washington, D.C.: U.S. General Accounting Office January 2004), 39.

⁹ Ibid.

¹⁰ Gale Group, Inc., "For What its Worth: It's Not Just the Money that Motivates, It's the Pay-for-Performance Culture Too," *Business and Management Practices Sales & Marketing Management*, 156, no. 8, (August 2004): 17, [database on-line], available from Lexis-Nexis; accessed 09 November 2005. . The survey cited, and the basis for the statistics, was conducted by the human resources consultancy Hewitt Associates and World Work, a trade association for compensation professionals.

¹¹ "Exelon: Fact Sheet," linked from the *Exelon Home Page*, available from <http://www.exeloncorp.com/NR/rdonlyres/69806D37-CEEC-405F-BDF4-311A96638A3B/1643/ExelonFactSheet012606.pdf>; Internet, accessed 7 January 2006. Exelon Corporation is one of the nation's largest electric utilities with more than \$14 billion in annual revenues. It distributes electricity to approximately 5.2 million customers in Illinois and Pennsylvania, and gas to 460,000 customers in the Philadelphia area. It operates the largest nuclear fleet in the nation and the third largest fleet in the world.

¹² Bob Shields, "Restructuring Utility Leadership; How Exelon Uses its Human Resources Department as a Strategic Weapon," *Public Utilities Fortnightly*, (September 2005): 25, [database on-line], available from Lexis-Nexis™ Academic; accessed 9 November 2005.

¹³ Ibid.

¹⁴ *Federal Register*, 66124.

¹⁵ John R. Deckop, Kimberly K. Merriman, and Gary Blau, "Impact of Variable Risk Preferences on the Effectiveness of Control by Pay," *Journal of Occupational and Organizational Psychology* 77, (March 2004): [database on-line], available from ProQuest; accessed 3 November 2005.

¹⁶ Ibid.

¹⁷ Ibid.

¹⁸ Deckop, Robert Mangel, and Corol Cirka, "Getting More Than You Pay For: Organizational Citizenship Behavior and Pay-for-Performance Plans," *Academy of Management Journal*, 42, no.4, (August 1999): 420. Organizational Citizenship Behavior is defined as employee behavior that goes above and beyond the call of duty, that is discretionary and not explicitly or directly recognized by the formal reward system and in the aggregate contributes to organizational effectiveness (Organ, 1988; Smith, Organ, & Near, 1983).

¹⁹ Ibid., 422. This study examined eight large, investor-owned gas and electric public utility companies from across the United States. Utilities tend to be larger and more hierarchical than other organizations, as quasi-public entities they are subject to different political forces than private sector employees and as pay-for-performance employees, they tended to have higher levels of education. As such, it appears reasonable to equate the results to those one might find if the study involved DoD employees.

²⁰ Raphael L. Vitalo, "Utility Analysis: An Overview," linked from the Vital Enterprises Home Page "Share/Learn," available from http://www.vitalentusa.com/learn/utility_analysis_overview.php; Internet accessed 14 February 2006. The concept of utility was originally introduced by Brogden (1949) and Brogden and Taylor (1950) and further developed by Cronbach & Gleser (1965). The concept has been researched and extended by Cascio (1982); Schmidt, Hunter, and Pearlman (1982); and Reilly and Smither (1983), among others. It was introduced as a method for evaluating the organizational benefits of using systematic procedures (e.g., proficiency tests) to improve the selection of personnel but extends naturally to evaluating any intervention that attempts to improve human performance. **Utility Analysis** is a quantitative method that estimates the dollar value of benefits generated by an intervention based on the improvement it produces in worker productivity. Utility analysis provides managers information they can use to evaluate the financial impact of an intervention, including computing a return on their investment in implementing it. It is based on the assumptions that human performers generate results that have monetary value to the organizations that employ them and that human performers differ in the degree to which they produce results even when they hold the same position and operate within like circumstances. The direct implication of these assumptions is that the level of results produced by performers in their jobs has different monetary consequences for the organizations that employ them. Performers are differentially productive and the productivity of performers tends to be distributed normally.

²¹ Michael C. Sturman, Charlie O. Trevor, John W. Boudreau, and Barry Gerhart, "Is it Worth it to Win the Talent War? Evaluating the Utility of Performance-Based Pay," *Personnel Psychology*, 56, no. 4, (Winter 2003, 997 [database on-line]; available from Wilson OmniFile; accessed 9 November 2005.

²² Ibid. 1000

²³ Ibid. 1010-1012. The study cites examples of both direct and indirect movement expenses associated with workforce transition. Direct expenses include separation costs (e.g., exit interview, separation pay), replacement costs (e.g., advertising, travel expenses, interviewing, and testing candidates), and training costs (e.g., informational literature costs, paying trainers). Indirect expenses include: lower productivity of new employees as they learn the job, time spent by managers having to supervise new employees more directly, and diminished productivity of veteran employees as they mentor and help new employees.

²⁴ Ibid. 1025

²⁵ Ibid., In the Sturman, et.al., study of *Utility Analysis*, payoff value represents the sum of employee Service Value (measured in terms of employee productivity), Service Costs (the costs to retain the workforce: pay and benefits) and Movement Costs (the costs associated with employee turnover: separation expenses, replacement costs, training costs, productivity costs training and supervising new hires).

²⁶ Ibid., 1025-1026.

²⁷ Ibid.

²⁸ Alexander D. Stajkovic and Fred Luthans, "Differential Effects of Incentive Motivators on Work Performance," *Academy of Management Journal* 44, no.3, (June 2001); 581-582

²⁹ Ibid., 582.

³⁰ Ron Moore, "Change: How Do We Manage It?," *Plant Engineering* (1 April 2003): 22 [database on-line]; available from LexisNexis; accessed 9 November 2005.

³¹ Ibid.

³² U.S. General Accounting Office, 39.

³³ Federal Register. 66118-66119.

³⁴ Michael Hayes, "Pay for Performance," *Journal of Accountancy* 193, no. 6, (June 2002): 24-28.

³⁵ Jamie Hale and George Bailey, "Seven Dimensions of Successful Reward Plans," *Compensation and Benefits Review*, (July 1998), 71-77 [database on-line]; available from LexisNexis; accessed 9 November 2005.

³⁶ Ibid.

³⁷ Michael Hayes, 25-26

³⁸ Sarah Fister Gale, "Incentives and the Art of Changing Behavior: Part 1 of 2," *Workforce Management*, (1 November 2002), 80 [database on-line]; available from LexisNexis; accessed 9 November 2005.

³⁹ Ibid.

⁴⁰ Michael C. Sturman, Charlie O. Trevor, John W. Boudreau, and Barry Gerhart, 1025-1027. The study refers to these tangible benefits in the private industry vernacular of, "potentially high payoff from investments in performance-based pay." The "negative consequences" refer to: Service Costs (the costs to retain the workforce: pay and benefits) and Movement Costs (the costs associated with employee turnover: separation expenses, replacement costs, training costs, productivity costs training and supervising new hires).

⁴¹ Sarah Fister Gale. 41

⁴² Craig J. Cantoni, "Learn to Manage Pay and Performance Like an Entrepreneur," *Compensation and Benefits Review*, (January 1997): 52-58 [database on-line]; available from LexisNexis; accessed 9 November 2005.

⁴³ Ibid.

⁴⁴ Ibid.

⁴⁵ "Evaluations, Cronyism and Pay; [Final Edition], *The Washington Post*, 7 November 2005 [database on-line]; available from ProQuest; accessed 21 November 2005.

⁴⁶ Phaedra Brotherton, "Meyners Pays for Performance," *Journal of Accountancy* 196, iss. 1, (July 2003): 41 [database on-line]; available from ProQuest; accessed 3 November 2005.

⁴⁷ Ibid.

⁴⁸ *National Security Personnel System Home Page*, available from <http://www.cpms.osd.mil/nsps/>; Internet; accessed 18 February 2006.

⁴⁹ Department of Defense, "Quadrennial Defense Review Report," available from <http://www.defenselink.mil/qdr/report/Report20060203.pdf>; Internet; accessed 18 February 2006. As stated in the QDR, the NSPS addresses three major personnel issues facing the Department of Defense. In addition to the two cited in this paper: staffing the enterprise to support 21st century missions and using compensation to compete more effectively in the broader labor market, the third issue is providing civilian support to contingency operations. Certainly, the pay-for-performance implementation strategy presented in this paper could result in the development a workforce more capable and ready to support contingency operations. However, an examination of the research and experience related to confirming that particular link was beyond the scope of this paper